No. 92-1974

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA

Petitioner,

v.

LEONARD HELFAND and EILEEN HELFAND,

Respondents.

On Petition For Writ Of Certiorari To The California Court of Appeal, First Appellate District, Division Four

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REPLY MEMORANDUM

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REPLY MEMORANDUM

Petitioner National Union seeks summary reversal of the decision below of the California Court of Appeal, which nullified an order of a United States Bankruptcy Court regarding a matter within the exclusive federal bankruptcy jurisdiction. In opposition, respondents make two arguments: (1) that the state court had subject matter jurisdiction to decide that respondents are "not bound" by the bankruptcy court's order approving an agreement between the debtor and National Union canceling and revising the debtor's insurance coverage because respondents were not "parties" to the bankruptcy proceedings; and (2) that the California court did not actually nullify the bankruptcy order, but rather correctly interpreted the "scope" of its "binding effect." *See* Opp. at 1-2. Both arguments are meritless, and this Court should summarily reverse to rectify what is a clearly erroneous, extraordinary and flagrant intrusion by the California courts into an exclusively federal domain.

1. Respondents are unable to cite a single case that holds that a state court has subject matter jurisdiction to entertain a collateral attack on a federal bankruptcy court order disposing of property that is part of the debtor's estate. That is because the courts—federal and state—have uniformly rejected that argument. *See* Pet. at 17-18. Indeed, the California Court of Appeal itself has squarely held that " 'Congress' grant to the federal courts of exclusive jurisdiction over bankruptcy petitions *precludes* collateral attacks on such petitions in state courts.' " *Gene R. Smith Corp.* v. *Terry's Tractor, Inc.*, 209 Cal. App. 3d 951, 954, 257 Cal. Rptr. 598, 599 (1989) (citations

omitted; emphasis added), *cert. denied*, 494 U.S. 1016 (1990).[1]

Respondents are therefore left to argue that the California Court of Appeal had jurisdiction here to allow respondents to enforce an insurance contract that had been canceled by the bankruptcy court because state courts are empowered to determine the "*res judicata* effect of a prior federal judgment." Opp. at 17. According to respondents, the California court was entitled to decide that respondents "are *not bound*" by the bankruptcy order, Opp. at 18 (emphasis in original; citation omitted), despite its otherwise binding effect because respondents "were not parties to the bankruptcy litigation, had not received adequate notice thereof, and did not appear therein."[2]

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[1] The principal cases relied on by respondents are inapposite. For example, *Shapiro* v. *Republic Indemnity Co. of America*, 52 Cal. 2d 437, 341 P.2d 289 (1959) (Opp. at 7, 8, 21), is not a bankruptcy case and concerned an initial suit in state court followed by another suit in state court, rather than a bankruptcy determination in a federal court followed by a state-court suit. Nor did *Parsons Steel Inc.* v. *First Alabama Bank*, 474 U.S. 518 (1986) (Opp. at 2, 17, 19, 22) involve issues relating to the exclusive bankruptcy jurisdiction of the federal courts. The proposition cited from *Parsons*, 474 U.S. at 525—that challenges to the correctness of a state court's determination as to the conclusive effect of a federal judgment must be pursued by way of appeal through the state-court system (rather than federal court injunction of the state-court proceedings) and certiorari from this Court—describes exactly the course that National Union is now pursuing. *Parsons* thus in no way undercuts or even relates to National Union's argument that respondents could obtain relief only in the bankruptcy court because all other courts lacked jurisdiction.

[2] Respondents advanced this argument, and the court below accepted it, even though respondents' claim for an additional $10,000,000 of coverage pursuant to the canceled policy is based

Opp. at 18-19. That, however, is a classic collateral challenge to the bankruptcy court's judgment that could be made, if at all, *only* in the federal courts that had exclusive subject matter jurisdiction over the insurance policy cancellation. Indeed, whatever power state courts ordinarily may possess to make determinations with respect to the binding effect of federal judgments generally, that authority is completely lacking in the bankruptcy context. Pursuant to the Bankruptcy Clause of the Constitution, Congress has created an exclusive federal vehicle for making such challenges that respondents chose to ignore. *See* Pet. at 18-20. Congress thereby "oust[ed] the jurisdiction of the State court" and that renders the judgment below "not merely erroneous but . . . beyond [the State court's] power, void." *Kalb* v. *Feuerstein*, 308 U.S. 433, 438 (1940).[3]

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on assignments from the directors and officers of the debtor, who were parties to the bankruptcy proceedings. Pet. App. 36a.

[3] "It is clearly within Congress' powers to establish an exclusive federal forum to adjudicate issues of federal law in a particular area that Congress has the authority to regulate under the Constitution," *International Longshoremen's Assoc.* v. *Davis*, 476 U.S. 380, 388 (1986) (citing *Kalb*), and "[e]nactment of such exclusive jurisdiction must, by operation of the Supremacy Clause, pre-empt conflicting state-court jurisdiction." *Id.* at 394 n.11. Although National Union repeatedly argued below that the California courts were intruding on the exclusive federal bankruptcy jurisdiction (Pet. App. 110a, 116a, 119a-26a, 141a-45a, 160a-66a, 171a-75a, 182a-85a), respondents complain that it did not make the precise jurisdictional argument below that it raises in this Court. Respondents do not, however, assert that National Union waived the subject matter jurisdiction point, and for good reason. Where, as here, Congress sets up an exclusive federal jurisdictional scheme, that constitutes "a nonwaivable foreclosure of the state court's very jurisdiction to adjudicate." *Longshoremen*, 476 U.S. at 389.

2. Respondents' argument that the California courts "in no way ignored the bankruptcy order or declared it a nullity," Opp. at 20, is equally unavailing. Indeed, respondents' own opposition leaves no doubt that the proceedings below with respect to the third year of coverage under the canceled insurance policy had but one purpose and consequence: to sweep aside the bankruptcy court's order to permit respondents to collect insurance proceeds that had been extinguished by that order.

Although the bankruptcy court explicitly held that adequate notice had been "provided to *all* parties entitled thereto," Pet. App. 199a (emphasis added), respondents concede that the inquiry below focused on—and reversed—the bankruptcy court on precisely that issue: "[w]ere the [respondents] given a full and fair opportunity to appear in the bankruptcy proceedings and protect their interests?" Opp. at 22. Respondents also concede that, had the California courts agreed with the bankruptcy court that notice of the bankruptcy proceedings leading to cancellation was sufficient, respondents "*would have* been bound." Opp. at 20 (emphasis in original).

Similarly, whereas the bankruptcy court order approved the agreement canceling the insurance policy, the California trial court ruled that it "is not bound by the Bankruptcy Court's . . . order even if it purports to authorize the cancellation." Pet. App. 81a. The Court of Appeal affirmed, concluding that National Union had a right to cancel the policy in "good faith" but that it "did not act in good faith in seeking cancellation" from the bankruptcy court, Pet. App. 34a, and that the "new deal" approved by the bankruptcy court was "arbitrary" because it "solely ben-

efited National Union and [the debtor]." Pet. App. 51a. State courts are not, however, vested with authority to decide whether a party to a bankruptcy proceeding acted in "good faith" or "bad faith" or whether a compromise approved by a bankruptcy court arbitrarily benefited the debtor and its creditors at the expense of third parties:

> Such an exercise of authority would . . . subvert the exclusive jurisdiction of the federal courts by allowing state courts to create their own standards as to when persons may properly seek relief in cases Congress has specifically precluded those courts from adjudicating.

Gonzales v. *Parks*, 830 F.2d 1033, 1035 (9th Cir. 1987) (only remedy for alleged "abuse of process" in connection with bankruptcy proceeding was to file motion for sanctions of "bad faith" litigation conduct in federal court).

Finally, the practical effect of the decision below makes clear that the California courts have nullified the bankruptcy order. The bankruptcy court order approved a compromise agreement by which the existing director and officer liability policy was canceled, a new policy covering the directors and officers for post-bankruptcy acts was substituted and no other premium was due for the additional coverage. Pet. App. 196a-97a. But the California Court of Appeal affirmed a finding that the cancellation was *invalid*, that the policy *remained in effect*, and that the post-bankruptcy directors and officers were entitled to coverage under the new policy *only* if the debtor paid National Union an *additional premium*. Pet. App. 88a.

Consequently, even the trial court has candidly recognized that it nullified the bankruptcy court's order approving the compromise. In *McLaughlin* v. *National Union*, A05115 (Cal. Ct App.) (appeal pending), one of the insurance bad faith actions against National Union which followed this action, the trial court instructed the jury: "Cancellation of the third year of the D&O policy was *invalid*, and had no effect on plaintiffs herein, *a bankruptcy order to the contrary notwithstanding*." Pet. App. 29a-30a, 201a (emphasis added).

August 2, 1993

Respectfully submitted,

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